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Social trust and central-bank independence

Niclas Berggren [a,b,*], Sven-Olov Daunfeldt [c,d], Jörgen Hellström [e]

[a] Research Institute of Industrial Economics (IFN), Stockholm, Sweden
[b] Department of Institutional Economics, Faculty of Economics, University of Economics in Prague, Czech Republic
[c] HUI Research, Stockholm, Sweden
[d] Department of Economics, Dalarna University, Borlänge, Sweden
[e] Umeå School of Business and Economics, Umeå University, Umeå, Sweden

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ABSTRACT

Central banks have become more independent in many countries. A common rationale has been the existence of a credibility (or lack-of-trust) problem for monetary policy. This indicates a possible and until now unexplored link between social trust and central-bank independence. Our empirical findings, based on data from 149 countries, confirm such a link, in the form of a u-shaped relationship. We suggest that two factors help explain this finding: the *need* for this kind of reform and the *ability* with which it can be implemented. At low trust, the need for central-bank independence is sufficiently strong to bring it about, in spite of a low ability to undertake reform. At high trust, the ability to undertake reform is sufficiently strong to bring high independence about, in spite of a low need for it. At intermediate trust levels, lastly, neither need nor ability is strong enough to generate very independent central banks.
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1. Introduction

Social trust – as measured by the share of people who think that most people can be trusted – seems conducive to the reaching of quite a few social and economic goals. For example, it is positively related to economic growth (Zak and Knack, 2001; Berggren et al., 2008), GDP per capita (Dearmon and Grier, 2009), trade (Guiso et al., 2009), stock-market size (Guiso et al., 2008) and financial integration (Ekinci et al., 2009). Societies in which people think that most people can be trusted thus tend to exhibit many widely valued qualities that are lacking in low-trust societies.

We propose to study whether trust affects central-bank independence. Pinpointing the determinants of this kind of independence is of interest, since previous studies have generally found it to entail low inflation rates — see, e.g., Brumm (2006), Acemoglu et al. (2008), Crowe and Meade (2008) and Klomp and de Haan (2010a). Our hypothesis is that social trust is a factor of importance — in fact, there is a connection between the rationale for making central banks more independent and trust, since the quest to give central banks an independent role largely builds on a perceived credibility (or lack-of-trust) problem. According to the literature on time-inconsistency in monetary policy, starting with Kydland and Prescott (1977) and Barro and Gordon (1983), policymakers have an incentive to renege on their pronounced inflation goals through surprise inflation, which causes the public

* Corresponding author at: Research Institute of Industrial Economics (IFN), P.O. Box 55655, SE-102 15 Stockholm, Sweden. Tel.: +46 8 665 45 20; fax: +46 8 665 45 99.
E-mail address: niclas.berggren@ifn.se (N. Berggren).

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to eventually not trust announcements of such goals.[1] The equilibrium outcome is the inflation rate at which no further gains can be obtained through inflation surprises. This situation entails inefficiently high inflation with no reduction in unemployment. Rogoff's (1985) solution involves the delegation of monetary policymaking to a conservative central banker, that is, one that puts a lower weight on the loss associated with unemployment than policymakers, resulting in lower inflation in equilibrium. Despite this connection, no previous study has to our knowledge analyzed the relationship between social trust and central-bank independence.

We study social and not particularized trust. The former is unrelated to information about specific persons or organizations – it captures a basic outlook on people in general – while the latter refers to trust in people or organizations that one knows or knows something about. Our primary motivation for looking at social trust is that we theorize that central-bank independence is a function of trust towards "everybody", since a decision to delegate power arguably depends on an assessment, by those undertaking the delegating, of the reactions of very broad groups of unidentified actors, such as politicians, voters and civil servants. Only social trust, we argue, fully captures this broad, trusting outlook that is related to a willingness to undertake reform.[2]

To understand the relationship between trust and central-bank independence we propose two mechanisms that work in opposite directions. On the one hand, there is the *ability* to undertake reforms. This ability is positively related to trust: the more people trust others, the easier it is to agree on delegation of power and to overcome social conflict and strife. On the other hand, there is the *need* for reform. In a setting with low trust, the credibility problem of monetary policy is plausibly very high, and the need to implement central-bank independence reforms is therefore seen as more urgent. At high trust levels, this need is much smaller, since trust can be seen as an informal institution that serves as a substitute for a credible formal institution. In all, the two factors identified indicate a non-linear relationship between trust and central-bank independence. If the need is sufficiently strong at low trust levels, and if the ability is sufficiently high at high trust levels, we obtain a u-shaped relationship when putting the two mechanisms together.

We investigate the relationship empirically by making use of Arnone et al.'s (2009) central-bank independence index.[3] Social trust is defined as the share of the population that thinks that most people can be trusted. Previous studies of the determinants of central-bank independence do not include social trust but rather focus on factors such as interest groups and political institutions (Posen, 1993), past inflationary experience and political instability (de Haan and van't Hag, 1995), inflation aversion (Hayo, 1998), checks and balances and the design of the political system (Moser, 1999), political fragmentation, legal culture and labor-market structure (Hayo and Hefeker, 2002) and socio-political turbulence and a balance of power between the executive and the legislature (Carmignani et al., 2008).

This study most closely relates to Hayo and Voigt (2008), who look at the effects of judicial independence and trust in the legal system on central-bank independence and inflation rates. They find that both factors are positively related to independence and negatively related to inflation rates. The idea is that there is a second-order commitment problem (Moser, 1999), such that politicians may have an incentive to influence monetary policy by trying to intervene in the work of the independent central bank, and that an independent and trusted legal system may make such attempts difficult to undertake. The trust measure, and the suggested mechanism for why this kind of trust matters, is different compared to the one used in this study. We also use another outcome variable: a broad central-bank independence index instead of the turnover rate of central-bank governors (although we use the latter measure in a robustness test).

Our results indeed suggest a u-shaped relationship between social trust and the level of central bank independence. In general, low- and high-trusting societies both tend to delegate considerable power from politicians to independent central bankers, while countries with intermediate levels have a lower degree of independence. Thus, the institutional framework in this area seems to be affected by the level of social trust, a relationship that has not been recognized previously.

2. Theoretical preliminaries

We argue that the relationship between social trust and central-bank independence is a function of two factors: the ability to establish independence and the perceived need to do so. Social trust affects these two factors, which in turn affect the probability and magnitude of reform. As the level of central-bank independence is the end result of a period of reforms, social trust can therefore also be expected to influence this level.

2.1. The ability to undertake central-bank independence reform

In order for mutually beneficial agreements to come about, actors need assurance that they will not be exploited by opportunists and that agreements are reliable. As explained by Knack and Keefer (1997), this can come about through written

[1] Even though the empirical evidence for time inconsistency is not conclusive, several studies suggest that it is a real problem (see, e.g., Ireland, 1999; Berlemann, 2005; Sachsida et al., 2011).

[2] This is not to say that it would not be of interest to study the effects on central-bank independence of trust in the central bank as well: such an analysis would be complementary to this one. However, at this point, there are to our knowledge no cross-country data on trust in central banks, so this will have to be a topic for future research.

[3] Note that our dependent variable is the level of central-bank independence, while the theory discusses factors that affect central-bank reforms. This forms a consistent story if one views the level as the end result of a period of reforms, which took place in many countries in the 1990s.

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